

China introduces new Export Tax Rebate policy

While the recent export tax rebate rate cut in China creates extra VAT costs that may weaken the competitiveness of export companies in the international market, it also improves firm liquidity position resulting from a timely settlement of tax rebates in arrears.

Background

Like other WTO members, China has adopted a tax rebate system since 1985 to expand exports and increase the competitiveness of exporting enterprises in the international market. The export rebate rate averaged some 15 per cent in the past, and funds needed for export rebates were all financed by the Central Government. In recent years, however, with the rapid growth of China's exports, government revenues have failed to keep up with tax rebates due to export enterprises. Outstanding export VAT refund claims have increased from US\$10 billion in 1999 to over US\$30 billion at the end of 2003, with an annual increase of 36 per cent. On the other hand, however, the average annual increase in the Central Government's fiscal revenue is only about 20 per cent. As public finance of the Central Government cannot cover all funds needed for export rebates on a timely basis, there has been default in payment of refunds since 2000. The delayed payment of tax rebates has created fiscal pressure on the Chinese Government and affected the normal operation of export-oriented enterprises, as many companies faced the problem of insufficient working capital resulting from the delays in receipt of tax rebates.

Recent revision to export tax refund rates

To alleviate long-outstanding export refund claims and reduce the heavy burden on State finance, the Ministry of Finance and the State Administration of Taxation

recently issued an official document (Caishui [2003] No. 222) that represents a structural change to the VAT export refund policy of China. The tax refund rates have been changed from four to five rates, with an overall average reduction of 3 percentage points. The table on the next page provides different adjustments for various types of exported goods with effect from 1 January 2004.

Impact of the rate cuts on business operation

The cuts in the tax refund rate are in line with State policies to support exports of certain goods and restrict others. For example, the refund rate has been increased from 5 per cent to 13 per cent for enterprises producing certain agricultural and poultry products for export. On the other hand, in terms of exports that China does not promote, such as crude oil, the Government has reduced the tax rebate rate by a large margin or even abolished refunds. Although the annual growth rate of exports for some industries may be affected because of the dropped tax refund rate, China's overall exports are unlikely to be significantly affected since exports are still more profitable than domestic sales.

However, lowering the tax rebate rate may create some negative impact on export-oriented enterprises. First, it reduces the rate of return on products that companies sell overseas. For example, if a company imports raw materials worth US\$100 and sells the

product at a price of US\$140 with the gross profit of US\$20. When the refund rate drops one percentage point, the gross profit rate of the product will drop from 14.3 per cent to 13.3 per cent according to the VAT rate of 17 per cent. In general, those enterprises that export most of the production with small profit margin will suffer the most from the reduced refund rate. Moreover, the tax rebate rate cut weakens export enterprises' competitiveness in the international market because of the extra cost of sales created. However, in the long run, it is expected that the relatively low labour cost in China will set off the additional VAT costs created and enable Chinese export products to remain competitive in the international market.

Though the reduced tax refund rate increases the costs of exported products, it is expected that the expedited payment of the tax rebate under the new policy will improve the cash flows of export enterprises and save them some operating costs. The Central Government guarantees that increases in central import duties will first be used to pay tax rebates, and thus, no new debt is likely in the future. Local governments will share, on a 25 per cent:75 per cent basis, fiscal burdens with the Central Government in this regard. The central government also guarantees payments of old debts with interest. However, the Government has not set a timetable by which all old debts owed thus far will be settled.

Some observations

The new policy provides only a temporary solution to ease the heavy burden on State finance. To completely solve the problem of export rebates, China needs to restructure the current tax system. In developed economies, government's financial revenues usually come from income tax, complemented by turnover tax. The reverse is true in China where fiscal revenue comes primarily from turnover tax. In China, VAT takes up a major share in turnover tax and accounts for about 45 per cent of the Central Government's financial income. Since export tax rebates cover VAT, which constitutes a major proportion of the government's financial revenue, the zero-rated treatment and VAT rebates for export products actually removes a



Exported Goods	Before (1/1/2004)	VAT Refund Rate After (1/1/2004)	Change
Agricultural products with a current VAT export refund rate of 5% (e.g., soybeans)	5%	5%	0%
Agricultural products with a current VAT export refund rate of 13% (e.g., cotton); Industrial products processed with agricultural products as raw materials with VAT export refund rate at 13%; Goods with an export refund rate of 13% (excluding goods with refund rate to be revoked or reduced as mentioned below)	13%	13%	0%
Goods with the current refund rate of 17% (e.g., ships, automobiles and spare parts, aviation vessels, numerically controlled machine-tools, multifunctional machine-tools, unit construction machines, printed circuits, program controlled telephones, telegraphic switching apparatus, light-transmitting equipment, medical instruments and appliances, metallurgy equipment, rail locomotives, etc.)	17%	17%	0%
Wheat and maize flour, meat and edible offal of ducks, rabbits or hares, etc.	5%	13%	+8%
Products derived from natural resources: coke and semi-coke of coal, bituminous coal, light-burned and dead-burned (sintered) magnesite, feldspar, talc, steatite, etc.	13%, 15%, 17%	5%	-8% ~ -12%
Products derived from natural resources: unwrought aluminum, yellow phosphorus and other phosphorus, unwrought nickel, molybdenum ores and concentrates, etc.	13%, 15%	8%	-5% ~ -7%
Petroleum; unwrought zinc; coal and chemical fertilizers, etc.	13%, 15%, 17%	11%	-2% ~ -6%
Certain electronic machinery; clothes and textiles etc.; certain iron or steel articles, small hardware, organic or inorganic chemical materials, plastic-ware, toys, shoes, clocks and watches, ceramics and porcelain, fiber, rubber-ware, sports products, leather craft, travel utilities and luggage, etc.	15%, 17%	13%	-2% ~ -4%
Products derived from natural resources: crude oil, timber, wood, paper pulp, goat wool, eel fry, ore of rare earth metals, phosphorus ores, natural graphite, etc.	5%, 13%, 15%, 17%	0%	-5% ~ -17%

sizable proportion of the central public finance. Therefore, China should restructure the existing tax system to let income tax take over turnover tax as the principal component in its tax structure. This will minimise the impact on the Government's revenue of tax rebates due to fast growing exports.

In addition, to alleviate the financial burden on the Government in refunding VAT to exporters, the tax authorities should take a stricter stance with regard to the levying of VAT and the enforcement of administrative measures.

There are some loopholes in the current administration of export rebates in the country. Though VAT is shared by public finance of the central and local governments, VAT rebates were entirely borne by the central public finance in the past. Given this institutional arrangement, local governments may not have adequate incentives to verify whether certain tax rebates are justified and whether tax rebates are given to qualified taxpayers. Moreover, despite a normal rate of 17%, 'autonomous' preferential policy by local governments

is offered in many areas, and thus many enterprises do not pay the standard 17% VAT for products sold overseas. Finally, the tax authorities should aggressively attack tax evasion and tax rebate fraud. It is estimated that the amount of turnover tax actually collected accounts for only about 15% of the total amount payable. Tax evasion imposes great pressure on State finance.

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